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Written by Daniel Sayani on October 24, 2011

Citigroup Settles With SEC Over Fraud Allegations

Citigroup has agreed to pay $285 million to settle civil fraud charges that it misled buyers of complex mortgage investments just as the housing market was starting to collapse. The Securities and Exchange Commission brought forth the civil action against Citigroup, claiming that investors who bought into the deal (which involved, essentially, stuffing portfolios with risky mortgage — related investments, selling it to unsuspecting customers, and then betting against those investments) had been defrauded. The transaction involved a one-billion dollar portfolio of mortgage-related investments, many of which were handpicked for the portfolio by Citigroup without telling investors of its role or that it had made bets that the investments would fall in value. The SEC says that as investors lost millions, Citigroup made $160 million in fees and profits.

Citigroup neither admitted nor denied the SEC's allegations in the settlement. "We are pleased to put this matter behind us and are focused on contributing to the economic recovery, serving our clients and growing responsibly," Citigroup said in a statement.

The penalty is the largest involving a Wall Street firm accused of misleading investors before the financial crisis since Goldman Sachs & Co. paid $550 million to settle similar charges last year. JPMorgan Chase & Co. resolved similar charges in June and paid $153.6 million.

The SEC on Wednesday also brought a case against Credit Suisse, which played a smaller role in the transaction, and against one individual at each company. But those individuals were mid-level employees in each company's investment and trading departments; no senior executives at either company were charged. Credit Suisse, which managed the portfolio of mortgage bonds that served as collateral for the deal, agreed to pay $2.5 million, half of it in penalties, to settle the case. The company declined to comment, and Samir H. Bhatt, 37, a former portfolio manager at Credit Suisse, also settled, paying no fine but agreeing to a six-month suspension from association with any investment adviser.

All the cases have involved complex investments called collateralized debt obligations. Those are securities which are backed by pools of other assets, such as mortgages. Citigroup's payment includes the fees and profit it earned, plus $30 million in interest and a $95 million penalty. The money will be returned to the investors, the SEC said. Neither the SEC nor the Justice Department would say if the case raised questions about whether Citigroup had been involved in any criminal wrongdoing.

At the height of the financial crisis in 2008, regulators worried that Citigroup was on the brink of failure. It received $45 billion as part of the $700-billion government bailout. In the civil lawsuit filed

Wednesday, the SEC said Citigroup traders discussed in late 2006 the possibility of buying financial instruments to essentially bet on the failure of the mortgage assets being assembled in the deal.

Rating agencies downgraded most of the investments that Citigroup had bundled together just as many troubled homeowners stopped paying their mortgages in late 2007. That pushed the investment into default and cost its buyers — hedge funds and investment managers — several hundred million dollars in losses. Among the biggest losers were Ambac, a bond insurer, and BNP Paribas, a European bank. Ambac had sold Citigroup protection against losses on the investment, allowing Citigroup to bet against it.

Citigroup has already settled one case stemming from the crisis. Last year, it agreed to pay $75 million to settle federal claims that it hid from investors vast holdings of subprime mortgage investments which were losing value during the crisis and which ultimately prompted the federal government to rescue the bank.

"The securities laws demand that investors receive more care and candor than Citigroup provided" to investors in the security, said Robert Khuzami, director of the SEC's enforcement division, referring to Wednesday's action. "Investors were not informed that Citigroup had decided to bet against them and had helped to choose the assets that would determine who won or lost."

The complex amalgamation of investments known as Class V Funding III produced $126 million in profits for Citigroup's brokerage subsidiary, and another $34 million in fees for putting it together. All of that, including interest and the $95-million fine, will now be going back to the investors; the government will not receive anything.

According to the SEC's complaints, the Class V Funding II transaction closed on Feb. 28, 2007. One experienced CDO trader characterized the Class V III portfolio in an e-mail as "dogsh*t" and "possibly the best short EVER!" An experienced collateral manager commented that "the portfolio is horrible." On November 7, 2007, a credit rating agency downgraded every tranche of Class V III, and on November 19, 2007, Class V III was declared to be in an Event of Default. The approximately 15 investors in the Class V III transaction lost virtually their entire investments while Citigroup received fees of approximately $34 million for structuring and marketing the transaction and additionally realized net profits of at least $126 million from its short position.

The SEC alleges that Citigroup and Stoker each violated Sections 17(a)(2) and (3) of the Securities Act of 1933. While the SEC's litigation continues against Stoker, Citigroup has consented to settle the SEC's charges without admitting or denying the SEC's allegations. The settlement is subject to court approval. Citigroup consented to the entry of a final judgment that enjoins it from violating these provisions. The settlement requires Citigroup to pay $160 million in disgorgement plus $30 million in prejudgment interest and a $95 million penalty for a total of $285 million that will be returned to investors through a Fair Fund distribution. The settlement also requires remedial action by Citigroup in its review and approval of offerings of certain mortgage-related securities.

In a statement, Citigroup noted that the SEC did not charge it with "intentional or reckless misconduct." Rather, it settled charges that its actions were negligent and misleading to investors. Despite its profits on the current deal, overall Citigroup lost tens of billions of dollars on its holdings of mortgage-related investments.

According to University of Denver law professor Jay Brown, the case bears striking similarities to the lawsuit the SEC brought against Goldman Sachs last year. On April 16, 2010, the SEC charged Goldman

Sachs and one of its vice presidents with defrauding investors by misstating and omitting key facts about a financial product tied to subprime mortgages as the U.S. housing market was beginning to falter. The SEC alleged that Goldman Sachs structured and marketed a synthetic collateralized debt obligation (CDO) that hinged on the performance of subprime residential mortgage-backed securities (RMBS). Goldman Sachs failed to disclose to investors vital information about the CDO, in particular the role that a major hedge fund played in the portfolio selection process and the fact that the hedge fund had taken a short position against the CDO.

One of the most striking similarities in the two cases is that both companies settled with the SEC "without admitting or denying" the government's accusations. The SEC's longstanding policy of using this phrase in its settlements is likely to come under scrutiny by the federal judge who must approve the Citigroup settlement — and it could, legal experts say, cause the deal to come undone. That is because the judge presiding over the SEC's action against Citigroup is Jed S. Rakoff of Federal District Court in Manhattan, a jurist whom many consider the adversary of SEC settlements, which he finds typically too lenient.

Judge Rakoff has sharply criticized the agency's practice of resolving cases without forcing the defendant to admit any wrongdoing. In a little-noticed ruling in March, he raised the specter of scuttling the next SEC settlement in his courtroom that included such language. Rakoff said the use of the "without admitting or denying wrongdoing" language created "a stew of confusion and hypocrisy unworthy of such a proud agency as the SEC." By using the boilerplate phrase, "only one thing is left certain: the public will never know whether the SEC's charges are true, at least not in a way that they can take as established by these proceedings," he wrote. He suggested that permitting the defendant to neither admit nor deny the misconduct was indefensible.

Photo: Citigroup headquarters in Manhattan, New York, New York